A Bond-Fund Mix Can Safely Stretch For Yield

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Bryce Doty, senior portfolio manager at Sit Investment Associates. Read the Q & A below as Bryce says that yield-hungry investors can pursue better payouts through closed-end funds without stretching dangerously for yield, though he notes they will want to diversify – and offers a number of promising funds to fill those varied portfolio slots – in order to better manage the risk that typically comes with pushing to get higher distributions.

Bryce Doty

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Bryce Doty, senior portfolio manager at Sit Investment Associates is here and we're talking about generating decent yields without stretching too far in these markets, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing The NAVigator's going to point you in the right direction. And today it's pointing us in the

direction of Bryce Doty, senior portfolio manager for Sit Investment Associates, and if you want to learn more about him and the firm it is SitInvest.com. But at Sit, well, among other things he manages more than $1.7 billion in closed-end fund of funds used in separate accounts, so he's evaluating and investing in closed-end funds for his clients all the time. And if you want to learn more about closed-end funds generally, check out AICAlliance.org, the website for the Active Investment Company Alliance. Bryce Doty, thanks for joining me on The NAVigator.

BRYCE DOTY: Yeah, thanks for having me, Chuck.

CHUCK JAFFE: These are really interesting times where we're watching what's happening with yields and interest rates. There's a very, very big yield squeeze and yet closed-end funds, well, they're kind of standing up. You can get an okay, not great historically speaking but okay for now yield, but you do have to be careful about stretching too far, right?

BRYCE DOTY: That is correct. The nature of closed-end bond funds is simply that they don't have to worry about liquidity. When first quarter of 2020 came along, you had all sorts of funds just taking hits and lots of people running for the doors. Closed-end funds didn't have to worry about any of that. They're like *Trading Places*, while everyone's panicking, it's Eddie Murphy going, "Buy! Buy!" and they're buying bonds really, really inexpensive. So they have really nice yields from bonds that they purchased back then. Right now you can get nearly 5% in a dividend yield in a lot of these investment-grade closed-end bond funds. High-yield bonds, not bond funds but just high-yield bonds are more like 4%, and that's junk. Here you can get an investment-grade fund with more income and pretty modest interest rate risk.

CHUCK JAFFE: Is it a straight tradeoff of liquidity, the closed side of things, for the better yield? Or is there more to it than that?

BRYCE DOTY: There is more to it. Closed-end bond funds have multiple levers that they can pull. So one thing that the SEC says that a closed-end fund can do that a normal mutual fund cannot do is they can borrow money. So it's still a 1940's Act registered mutual fund, but they can borrow up to 50% of the assets in the fund. And right now borrowing rates for some of these funds are less than a quarter of a percent. So they can post-collateral their existing bonds to get this really low rate, and they take the money and they invest it in one or two or three percent bonds and that boosts the overall yield of the fund. You can't get that in an ETF. You can't really get that-- well, there's some, but most of them you can't, and you can't really

get that in a normal mutual fund. Another thing, these funds are doing some other things that other funds just can't do. They'll invest in not just illiquid things, but they'll also trade at prices that are not equal to their NAV. So you'll see a fund that says, "Hey, our shares are worth $10 a share," but you'll look on the New York Stock Exchange and they're trading at $9 a share. Because when you want your money back you have to find another buyer. You're not going to redeem your money from the fund and that oftentimes can drive the price lower than it should be. Well, you as the buyer benefit from that. You buy it cheap, you might have to sell it cheap. But if you're buying it at a discount, you naturally, naturally are getting a higher yield.

CHUCK JAFFE: Let me jump in here though, because closed-end funds trade based on market demand. Demand for yield right now is high, are you also seeing the discounts narrow or even premiums coming into play because there's so much demand for yield right now?

BRYCE DOTY: Yeah, there's a lot of momentum, there's a lot of demand for yield. So whenever we see the dividend yield on these funds be more than 2.5-3% over the Lehman Aggregate yield, which is about 1.5%. Anytime the dividend yields on closed-end funds are a good 3% over that, which they are, there is a lot of demand. People are chasing yield and they have narrowed those discounts significantly. Some funds are indeed at a premium, and I think they deserve it, until the gap narrows to maybe 2.5%. Between the Bloomberg Aggregate Bond Index and a typical investment-grade closed-end fund, I don't see those discounts widening back out. Maybe next year you'll start to see that, but for right now you're right, there's a lot of demand for income.

CHUCK JAFFE: So where are you turning to satisfy that demand from your investors? What closed-end funds are exemplars for what you want to be looking at right now?

BRYCE DOTY: Well, we like to mix, we like a combination of things. There's a DoubleLine fund, the ticker is DBL, has a 6% yield and only a 4 year duration. To be able to get a yield higher than the interest rate risk, higher than the duration is extremely difficult these days, and so we just like that kind of combination. That's mostly invested in mortgages, so you want different flavors. Another fund of a different flavor would be a corporate fund, this is an Angel Oak Dynamic Financial Strategies Fund, that's a long name, it's a mouthful, the ticker is DYFN. It's only yielding 4%, but that's still double what most A-rated corporate bonds are yielding, and it only has a 3.5 year duration. Again that great ratio of income to duration, and

because this is a term trust that duration is just going to get shorter and shorter and shorter. So if you have a 4-year horizon, who cares what the price does? You know you're going to get that 4% a year for 4 years. Another couple of Putnam funds, they're multi-sector funds, they have all sorts of stuff in there, even some derivatives. But PIM and PPT both yield over 6% and only have 3.5 years' worth of duration. Now granted the underlying sectors are more volatile, but you blend it with these other funds and it kind of evens itself out and you still get that great income. Lastly, we're afraid of inflation, okay?

CHUCK JAFFE: You and a lot of people.

BRYCE DOTY: Yeah, yeah. We like WIW, it's a Western Asset fund. And if you look at a TIPS treasury yield, the yield is negative and they're saying, "Well, you make up for it by the fact that the principal is growing at inflation. That's where you're really getting your return from." This fund actually has a positive dividend yield, plus gives you that kicker from the income, it's yielding 3%. One of the reasons it's yielding 3% is because you can get it at almost 9% below what the fund says its shares are worth. So we really love that, it's 88% treasury inflation protected securities.

CHUCK JAFFE: All of this, because you're using a mix it's diversifying to minimize the risk that you might otherwise be taking by stretching for yield.

BRYCE DOTY: Yes, that's really critical. By mixing all these funds, not only are you getting exposures to different sectors but each of the funds are diversified. So they have a hundred positions or more, and then you put five of them together you now have over 500 different bonds that you're exposed to. Let alone if you buy 10 or 15 funds, you're extremely diversified. So that really, really helps mitigate some of the risk that you're taking to get this kind of income. We didn't mention this yet but a lot of people are worried about taxes going up as well. There's some good tax-exempt funds, they're long though, you have to kind of keep that in mind. You have to kind of close your eyes to the volatility of the price, but if you're just focused on tax-free income there's some that are over 4%. There's a Nuveen fund right now that has a 4.6% yield, ticker is NEA, and if you think about what that 4.6% federally tax-exempt yield does for you, that's equivalent to getting a regular fund at 7%. That's incredible in this interest rate environment.

CHUCK JAFFE: It is incredible, Bryce, I wish we had more time. We don't, but we'll just have to have you back. Thanks so much for coming on The NAVigator with me.

BRYCE DOTY: Thanks for having me, Chuck. It was great to be here.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. That's me, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Bryce Doty, senior portfolio manager at Sit Investment Associates. Learn more about him and the firm at SitInvest.com. The NAVigator podcast is new every Friday, ensure that you don't miss anything by subscribing via your favorite app. And if you like us, please leave a review, they really do help. Until we are together to do this again, happy investing everybody.

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